Internal Control for Management and Auditors

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Objectives

At the end of this briefing, you will understand

- the background and definition of internal controls
- Management’s responsibility for internal control
- how internal controls are relevant to audits, including
  - the steps to follow in determining whether internal controls are significant to your audit objectives,
  - how the consideration and the impact of internal controls vary depending on different audit objectives, and
  - the requirements for documenting your considerations of internal control during the audit process.

Background and Definitions of Internal Control

Internal Control Frameworks
COSO

- Committee of Sponsoring Organizations of the Treadway Commission (COSO)
    - Developed internationally accepted and widely used framework and standards for internal control.
    - COSO standards form the basis for the frameworks and definitions that we are going to discuss today.
- COSO led the way and is the framework adopted by GAO in the Green Book, by INTOSAI, and most recently in OMB Circular A-123.
- The COSO framework is very broad, covers all aspects of an entity’s management and operations, with an emphasis on program performance.

Internal Control Requirements
FMFIA/OMB A-123

- Federal Financial Managers Financial Integrity Act of 1982 (FMFIA) established the overall requirements for internal control in federal agencies. The agency head must establish controls that reasonable ensure that
  - Obligations and costs are in compliance with applicable law
  - Funds, property, and other assets are safeguarded against waste, loss, unauthorized use, or misappropriation, and
  - Revenues and expenditures applicable to agency operations are properly recorded and accounted for
- Over the years, OMB Circular A-123, has broadened these requirements to include controls over all aspects of an agency’s operations.

Management’s Responsibility for Internal Control

OMB Circular A-123

- Office of Management and Budget (OMB) Circular A-123, “Management’s Responsibility for Internal Control”
  - Implements FMFIA
  - Defines management’s responsibility for internal control in Federal agencies
  - Provides guidance to Federal managers on improving the accountability and effectiveness of Federal programs and operations
  - Covers all aspects of an agencies operations (programmatic, financial, and compliance)
  - Latest revision provides updated internal control standards (based on GAO’s Green Book) and new specific requirements for conducting management’s assessment of the effectiveness of internal control

Management's Responsibility for Internal Control
OMB Circular A-123

Six Major Requirements of Agencies and Federal Managers

1. Develop and implement internal controls
2. Assess the adequacy of internal controls
3. Separately assess and document internal control over financial reporting
4. Identify needed improvements
5. Take corresponding corrective action
6. Report annually on internal control

Management's Responsibility for Internal Control
OMB Circular A-123

Who is responsible for the development and implementation of internal control?

- Management is responsible for integrating internal control into all of its operations in a cost beneficial manner, in order to provide reasonable assurance that the entity's objectives and mission is being accomplished while safeguarding public funds (economy and efficiency, and safeguarding of public assets).

- Management is also responsible for monitoring the effectiveness of its internal control (operations) and the accomplishments of its objectives.

Management's Responsibility for Internal Control

OMB Circular A-123

Standards

Definition of internal controls
GREEN BOOK

- Internal control is an integral part of an organization's management that provides reasonable assurance that the agency's objectives are being met in the following categories:
  - Effectiveness and efficiency
  - Reliability of financial reporting
  - Compliance with laws and regulations
  - Safeguarding of assets
- Internal control serves as the first line of defense in safeguarding assets (including public funds) and preventing and detecting errors and fraud.
- Internal control helps managers achieve program results through effective stewardship of public resources.

General Objectives of Internal Controls GREEN BOOK

Internal control should achieve the following general objectives:

- orderly, ethical, economical, efficient, and effective operations.
- fulfilling accountability obligations, whereby public service organizations and the individuals within them are held responsible for their decisions and actions, including their stewardship of public funds, fairness, and all aspects of performance.
- compliance with laws and regulations.
- safeguarding resources against loss, misuse, and damage due to waste, abuse, mismanagement, errors, fraud, and irregularities.

The Green Book-- Demystified

What are the five internal control standards?

- The five standards for internal control address

  - Control Environment
  - Risk Assessment
  - Control Activities
  - Information and Communications
  - Monitoring

  - Source: *Standards for Internal Control for the Federal Government*, GAO/AIMD-00-21.3.1, Nov. 1999

Control Environment– Green Book/ INTOSAI

The Control environment sets the tone of an organization, influencing staff awareness of good controls, procedures, accountability, and program management. It is the foundation for all other components of internal control, providing discipline and structure.

Elements of the Control environment are:

- Personal and professional integrity and ethical values of management and staff, including a supportive attitude toward doing things right
- Commitment to competence
- Tone at the top
- Organizational structure
- Human resources policies and practices

Control Environment– Red Flags/Risks

- The following are indicators of risk that the agency may not have a strong control environment
  - The agency or program has recently undergone major change– e.g. new responsibilities, reorganization, cuts in funding, expansion of programs, changes in management
  - Management does not address indicators of problems.
  - Employees do not understand what behavior is acceptable or unacceptable, or are generally disgruntled.
  - Top management is unaware of actions taken at the lower level of the organization.
  - It is difficult to determine the organizations or individuals that control programs or particular parts of a program.
  - The organizational structure is inefficient or dysfunctional.

Control Environment-- Demystified

- Basically, an entity (or program) with a good control environment is a well managed organization with good accountability mechanisms throughout the organization or program to help ensure that program objectives are achieved ethically, economically (without waste) and in a competent manner.
- A good control environment would include risk assessments of the internal and external environments which are revisited periodically and used throughout the strategic planning process.

Risk Assessment-- Green Book/INTOSAI

- Risk assessment is the identification and analysis of relevant risks associated with achieving program or agency objectives, such as those defined in strategic and annual performance plans, and forming a basis for determining how risks should be managed.
- Management should provide for an assessment of the risks the agency faces from both external and internal sources.
- Risk assessment generally includes estimating the risk's significance, assessing the likelihood of its occurrence, and deciding how to manage the risk and what actions should be taken.
- Risk assessment is important for decisions on allocating resources and responsibility (accountability).

Risk Assessment- Red Flags/Risks

- The agency or program does not have well-defined objectives.

  (If the agency does not know what it is trying to accomplish, it will not be able to adequately assess risks)
- The agency or program does not have adequate performance measures.

  (If you don't know how to measure success or whether the program is successful, you will not be able to adequately assess risks)
- The agency or program does not have an adequate strategic plan.
- Risk assessment is generally part of an overall strategic approach to management, and can also be an outgrowth of strategic management. If the agency is in general chaos, it is likely that adequate risk assessment is not occurring. In this situation, the reportable problems may be bigger/greater than a lack of adequate risk assessment.

Risk Assessment- Demystified

- Generally, risk identification and assessment is an ongoing, iterative management process related to strategic planning and defining of program objectives. Management uses the results of risk assessment in deciding how to allocate resources and mitigate risks, and what types of control activities and management involvement are needed.
- Management can take the following actions regarding risks:
  1. Transfer the risk to another party
  2. Take action to eliminate the risk (corrective action)
  3. Tolerate the risk (do nothing)
  4. Terminate the risk (do something to make it irrelevant)

Control activities- Green Book/INTOSAI

- Control activities are the policies and procedures established to achieve the entity's objectives. They help ensure that management's directives are carried out in daily program operations.
- Examples of control activities include
  - Authorization and approvals for transactions and other events.
  - Verifications and reconciliations.
  - Controls over access to assess, resources, and records.
  - Management-level reviews of program performance and other activities.
  - Documentation of transactions, approvals, and other significant management involvement in program activities.
  - Supervision, including assigning, reviewing work, training.
  - Development of formal policies and procedures to govern the above.

Control Activities-
Red Flags/Risks

- The agency or program has recently undergone major change– e.g. new responsibilities, reorganization, cuts in funding, expansion of programs, changes in management.
- Agency or program is understaffed and/or workload has drastically increased, and staff are having difficulties handling operational workload.
- There have been previous issues with fraud, waste, or abuse.
- Employees are unaware of policies and procedures, but do things the way “they have always been done.”
- Operating policies and procedures have not been developed or are outdated.
- Key documentation is often lacking or does not exist.
- Control environment is bad.
- Employee morale is bad.

Control Activities- Demystified

- Generally control activities are embedded into an agency’s overall policies and procedures (human capital, payroll, expenses reimbursements), as well as specific policies and procedures for operating a program (specific steps that need to be taken before actions or expenditures are made under as part of a program).
- Control activities can be thought of in two different ways:
  - specific actions that are directed toward achieving a particular objective (e.g. reasonable assurance that recipients of funds are eligible), or
  - Specific actions directed at mitigating a risk or avoiding a potential problem (e.g. specific procedures to prevent ineligible recipients form receiving funds)

Control activities- Demystified

- Control activities will likely represent the most detailed level of internal control work and analysis that you do when reviewing a program.

- You will frequently learn about control activities when gaining a detailed understanding of the program, and should ask targeted questions during this phase of the job.

- Whether or not an entity has effective control activities as part of its program can be negatively or positively impacted by the other control elements:
  - Control environment
  - Risk assessment
  - Information and Communications
  - Monitoring

Information and Communications- Green Book/INTOSAI

- Information is needed by management and employees to monitor progress in meeting the organization’s mission and objectives while maintaining proper accountability and internal control.
- Pertinent information should be regularly tracked and communicated throughout the organization (down, up, and across) so that employees in all levels of the organization understand their role in achieving the organization’s mission and objectives, and their roles and responsibilities in maintaining proper internal controls.
- Management’s ability to make appropriate decisions is affected by the quality of information available.

Information and Communications- Red Flags/Risks

- When top management needs information, there is a mad scramble to assemble the information, or the process is handled through ad hoc mechanisms. (e.g. the information was not readily available)
- Key information requests for basic information on the status of operations from external stakeholders (e.g. the hill or GAO) are difficult for the agency to respond to and require extra resources or special efforts.
- Management is using poor quality information or outdated information for making decisions.
- Staff are frustrated by requests for information because it is time-consuming and difficult to provide the information.
- Management does not have reasonable assurance that the information it is using is accurate.

Information and Communications-Demystified

- In order for management and employees to do their jobs effectively, both management and employees need certain information with regular communication mechanisms in place so that the organization can meet its objectives and maintain proper controls and accountability.

Monitoring- Green Book/INTOSAI

- Internal control systems should be monitored to assess their effectiveness and to modify procedures as appropriate based on results of the monitoring activities (feedback). Monitoring is accomplished through routine, ongoing activities, separate evaluations, or both.
  - Ongoing monitoring is built into the normal, recurring operating activities of an entity. It includes regular supervisory activities, reviews, and quality control procedures.
  - Separate evaluations performed by management may also be appropriate based on risk and the effectiveness of ongoing monitoring procedures.
- The monitoring process should also be used to ensure that audit findings and recommendations are adequately and promptly resolved.

Monitoring-
Red Flags/Risks

- Significant problems exist in controls and management was not aware of those problems until a big problem occurred or until another outside party brought it to their attention (e.g. a recipient of funding, or an external audit).
- The agency or program has recently undergone major change– e.g. new responsibilities, reorganization, cuts in funding, expansion of programs, changes in management.
- There are problems with the other control elements: control environment, risk assessment, control activities, information and communications.
- Previous audit findings are not being resolved adequately or timely.
- Program is in general chaos.

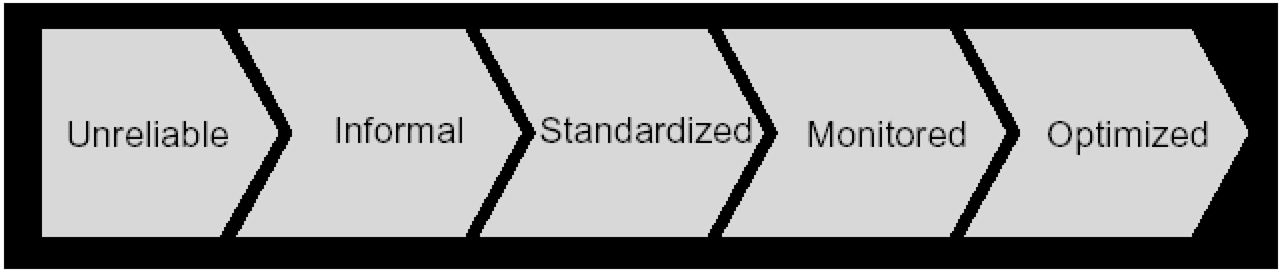
Monitoring- Demystified

- Effective monitoring of internal control, through daily procedures and/or separate evaluations, provides management with assurance that the internal control system is operating as intended or modified appropriately for changes in conditions.
- The monitoring function should also help ensure that known problems (such as audit findings, or issues detected in the monitoring process) are addressed and corrected.

The Bottom Line on Responsibility for Internal Control

- Management is responsible for the following, with regard to internal controls
  - designing,
  - implementing,
  - reviewing, and
  - improving.

INTERNAL CONTROL MATURITY MODEL FRAMEWORK

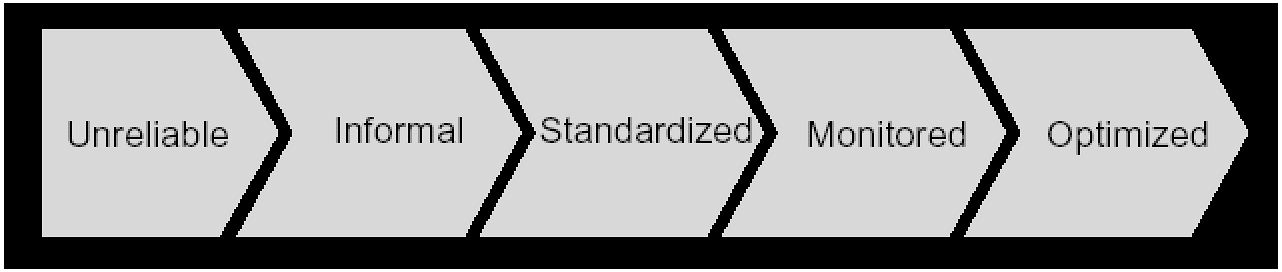


Internal Controls Maturity Framework: *Source: PricewaterhouseCoopers paper on Sarbanes Oxley Act of 2002*

- **<u>Level 1: Unreliable</u>**
- Unpredictable environment where **controls are not designed or in place.**

- **<u>Level 2: Informal</u>**
- Controls are designed an in place but are **not adequately documented**
- Controls mostly **dependent on people**
- No formal training or communications of controls.

INTERNAL CONTROL MATURITY MODEL FRAMEWORK

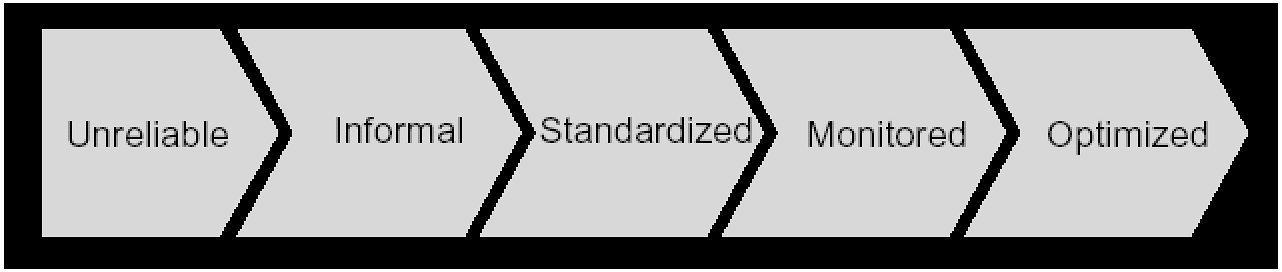


Internal Controls Maturity Framework: *Source: PricewaterhouseCoopers paper on Sarbanes Oxley Act of 2002*

- **<u>Level 3: Standardised</u>**
- Controls are designed and in place
- Controls **have been documented** and communicated to employees.
- Deviations from controls **may not be detected.**

- **<u>Level 4: Monitored</u>**
- Standardised controls with **periodic testing** for effective design and operation with reporting to management
- **Automation and tools** may be used in a limited way to support controls

INTERNAL CONTROL MATURITY MODEL FRAMEWORK



Internal Controls Maturity Framework: *Source: PricewaterhouseCoopers paper on Sarbanes Oxley Act of 2002*

- **Level 5: Optimised**

- An integrated internal control framework with **real-time monitoring** by management with continuous improvement (Enterprise-Wide Risk Management).
- **Automation and tools** are used to support controls and allow the organisation to make **rapid changes to the controls if needed.**

The Auditor’s Role in Internal Control

- The audit function is key to accountability of public programs and use of public funds.
- Consideration of internal control is considered a basic audit function for financial and performance audits, in U.S. and international standards.
- Yellow Book has specific requirement for considering internal control in the planning phase, when determining the objectives, scope and methodology for the job.

The Yellow Book

Definition of internal controls– Yellow Book

- Internal control includes the processes and procedures for planning, organizing, directing, and controlling program operations, and
  - the system put in place for measuring, reporting, and monitoring program performance.
- Internal controls help federal managers assess and manage the risks associated with their program
  - Internal controls are synonymous with “management controls”

Auditor’s Role in Internal Control

- GAO has taken the following position regarding “opinions” on internal control related to **financial** audits. The same principles apply to consideration of internal control in program audits.
  - Reporting on internal control is a critical component of monitoring the effectiveness of an organization’s risk management and accountability systems.
  - Auditors can better serve their clients and better protect the public interest by having a greater role in providing assurances over the effectiveness of internal control in deterring fraudulent financial reporting, protecting assets, and providing an early warning of problems.

Auditor’s Responsibility for Internal Control Performance Audits

- GAGAS Field Work Standards for Performance Audits--Planning
    - **Work is to be adequately planned.**
        - Planning **should be documented**, and should include**:**
            - Obtaining an understanding of internal control as it relates to specific objectives and scope of the audit and consider whether specific internal control procedures have been properly designed and placed into operation.

(Source: GAGAS 7.02, 7.07 c, and 7.11)

Auditor’s Responsibility for Internal Control
Performance Audits

GAGAS Field Work Standards for Performance Audits—Planning (cont.)

- Auditors need to consider whether they plan to modify the nature, timing, or extent of their audit procedures based on the effectiveness of internal control.

- If so, auditors should include specific tests of the effectiveness of internal control and consider the results in designing audit procedures.

(Source: GAGAS 7.11)

Auditor’s Responsibility for Internal Control Performance Audits

- Yellow Book also provides discussion of internal control objectives to help auditors better understand internal controls and determine significance to audit objectives.
  - Effectiveness and efficiency of program operations
  - Validity and reliability of data
  - Compliance with laws and regulations and provisions of contracts or grant agreements
  - Safeguarding of assets

(Source GAGAS 7.12 through 7.13)

Analyst’s Responsibility for Internal Control Performance Audits

Impact of internal controls on the audit plan:

- Poorly controlled aspects of a program have a higher risk of failure, so auditors may want to focus on those program aspects (audit objectives/scope)
- Knowledge that internal controls are not properly designed or functioning may lead auditors to focus on those areas (objectives/scope)
- Ineffective or effective controls will impact the extent of work the needed to support conclusions (audit methodology)

Source: GAGAS 7.14

Auditor’s Responsibility for Internal Control Performance Audits

- When internal controls are significant to the audit objectives, auditors should plan to obtain sufficient evidence to support their judgments about those controls. (GAGAS 7.15)
- Sufficient, competent, and relevant evidence is to be obtained to provide a reasonable basis for findings and conclusions as they relate to the audit objectives.

  (GAGAS 7.48 and 7.49)
- The report should include a description of the scope of work on internal control and any significant deficiencies found during the audit. (GAGAS 8.17)

Auditor's Responsibility for Internal Control Performance Audits

- In a performance audit, significant deficiencies in internal control may be identified as the cause of deficient performance. GAGAS 8.18
- If warranted, auditors should make recommendations for actions to correct problems and operations… Recommendations to improve internal control should be made when deficiencies in internal control are found. GAGAS 8.28

Yellow Book Exposure Draft (Internal Control revisions)

Chapter 4—Field Work Standards for Financial Audits

- The following changes have been made to update and clarify the standards for field work:
  - update of the AICPA field work standards cited to reflect recent AICPA changes (4.04)
  - update of the audit documentation standard for consistency with AICPA's new standard (4.22 – 4.41).

Yellow Book Exposure Draft (Internal Control revisions)

Chapter 5—Reporting Standards for Financial Audits

- The following changes have been made to update and clarify the reporting standards:

  update of definitions and terminology for internal control deficiencies to achieve consistency with PCAOB and AICPA terminology (5.12 – 5.15),

  clarification of reporting requirements for internal control deficiencies, (5.12 – 5.18)

Yellow Book Exposure Draft (Internal Control revisions)

Chapter 7 – Field Work Standards for Performance Audits

- The field work standards for performance audits have been significantly revised within a framework related to significance (materiality), audit risk, and reasonable assurance. The following change, related to internal control was made:
  - Audit documentation should include evidence of communications about deficiencies in internal control found during the audit. (7.77i)

Application of Internal Controls to Performance Audit Assignments

Internal Control Applicability Decision

- Identify the program, activity, or function being reviewed
- Determine whether there is **government management** or **oversight**
- If there is a government management or oversight role, it is highly likely that some of the internal control standards will be significant to your audit objectives.

Internal Control Applicability Decision

- Using your **professional judgment** and knowledge of the program decide whether the particular program that you are reviewing would be at risk if the agency did not have adequate controls.
  - If you decide the program would be at risk and your conclusions would be impacted by inadequate controls, then internal controls are significant to your audit objective.
  - If you are unsure about the above, ask yourself this question: If there is a significant problem with this program or the data we are being provided about the program,
    - would the requestor expect us to find it as a part of this engagement?
    - do I have a responsibility to do sufficient work to detect the problem?

Internal Control Applicability Reverse Analysis

- After gaining an understanding of the program or issue under audit, ask yourself the following questions based on everything you have learned:
  - What could go wrong with this program?
  - What is the probability of the above going wrong?
  - If the above goes wrong, would this call into question the audit conclusions on the engagement if we did not include this in the scope of our assignment?
  - In the above scenario, would someone ask, “How did the auditors miss this?”

Documenting your consideration of internal control

- Identify which, if any, of the internal control standards are significant to your audit objectives
- If some standards are significant, document the impact on the audit in workpapers
  - data analysis to be performed, and
  - what the analysis will allow you to say

Audit Questions About Risk

- What are critical program risks?

- Has the agency done a good job of identifying risks?

- What steps do we need to build into the audit plan, given what we know about the entity's risk management?

Control Activities and Risks

- The existence of program risk is not a problem
- Having risk beyond what is acceptable and not dealing with it is a problem
- Control activities are designed to deal with risk (provide reasonable assurance and consider costs versus benefits)
- Possible issues include controls missing, wrong or inadequate controls, and adequate controls not effectively implemented
- Controls that look good on paper need to be tested
- What entity representatives tell you about controls (testimonial evidence) needs to be corroborated or tested.

Audit Questions About Control Activities

- Are control activities well-designed to deal with risks?
- What has program management done to test implementation?
- When internal control issues have been identified internally or by external sources, what type or corrective action process exists to assure issues are resolved effectively?
- What documentation or other evidence exists that controls are working as intended?
- If control activities are not well-designed to deal with risk and/or if risk has not been adequately identified, the root cause of the problems can likely be found in the other four broad components of internal controls.

Control Environment

- Think of the control environment as the foundation for an effective internal controls program. Management must set the right tone
- If risk assessment is not adequate for the program or if control activities are not well-designed or implemented, something is not right in the control environment
- Questions to ask include:
  - How management evidenced interest in effective controls?
  - Is internal control accountability and process well defined?
  - Do human capital management approaches value internal controls?
  - Are there emergency or unusual situations that would call for normal controls to be lifted or additional risks to be accepted?

Information and Communications

- Think of information and communications as the flow of information up, down, and across the organization to make sure people know and meet their internal control responsibilities
- Root causes and additional findings and recommendations related to problems in risk assessment or control activities may also be evident in related information and communications.
- Questions to ask include:
  - Was adequate and timely information provided to help staff know and meet internal control responsibilities?
  - Did management receive adequate information to manage internal controls?

Monitoring

- Monitoring includes both efforts to continuously monitor program implementation of internal controls and periodic, more in-depth evaluations on controls effectiveness
- If there are problems evident in risk assessment and/or control activities, the logical question is why did the agency not discover the issues through program monitoring?
- Questions to ask include:
  - What sources of information were routinely available to management to inform them of control issues or concerns?
  - Did management have a plan for periodically evaluating critical control issues and/or issues identified by continuous monitoring?

Summary of Approach

- Identify program risks (assess agency efforts, consider other information sources

- Consider control activities designed to deal with risk (reasonable assurance, costs/benefits, test implementation)

- If problems exist in risk assessment and design or implementation of control activities, examine issues related to control environment, information and communication, and monitoring as suggested

Evaluating Internal Control as a Primary Engagement Objective

- Purpose of some engagements or at least a principal objective could be the evaluation of internal controls in a program

- Approach suggested earlier starting with program risks could be used in engagement planning.

- A straight-forward approach could start with: Assessing the control environment, examining agency risk assessment, examining and testing agency control activities, reviewing information and communications flow, and reviewing monitoring.

Questions

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